

Historic, archived document

Do not assume content reflects current scientific knowledge, policies, or practices.

A284.5
Ex82

UNITED STATES
DEPARTMENT OF AGRICULTURE
LIBRARY



BOOK NUMBER A284.5
914152 Ex82

UNITED STATES DEPARTMENT OF AGRICULTURE
Federal Extension Service
Washington 25, D. C.

NET OPERATING LOSS DEDUCTION

If a farmer had losses and expenses in 1955 which are greater than his gross income, he may be entitled to a refund of all or a part of the income taxes he paid for the years 1953 and 1954.

In order to find out whether he is entitled to a refund a series of computations must be made, because some of the deductions allowed in computing "taxable income" are not allowed in computing a "net operating loss." This circular has been prepared to explain these computations and to show how to compute the amount of the refund.

For the purpose of this discussion, let us assume a net loss for 1955 which is large enough to cause a refund of taxes for 1953 and 1954. Let us also assume that there are no other loss years. Under these circumstances, the necessary computations can be made in five steps:

1. Compute the amount of the 1955 "net operating loss."
2. Convert the 1955 "net operating loss" to a 1953 "net operating loss deduction."
3. Recompute the 1953 "net income" and determine the 1953 tax liability, if any, and the amount of the refund due.
4. Compute the amount of the 1955 "net operating loss" which is available as a "net operating loss deduction" in 1954.
5. Recompute the 1954 "taxable income" and determine the amount of the 1954 tax liability, if any, and the amount of the refund due.

STEP I - Computing the 1955 "Net Operating Loss"

There are several ways to compute the net operating loss. You may start with the amount shown on line 11, page 1, Form 1040 (Adjusted Gross Income) or the amount shown on line 5, page 2, Form 1040 (Taxable Income.) You may also start with gross income and deductions. This last method is the one illustrated here. In any event, the net operating loss is computed in the same manner as taxable income, except that:

- (a) No deduction for a net operating loss carryover or carryback from any year is allowed.
- (b) The deduction for capital losses may not exceed the capital gains included in gross income.
- (c) No deduction is allowed for 50 percent of the excess of a net long-term capital gain over a net short-term capital loss.

(d) No deduction for personal exemptions is allowed.

(e) Deductions which are not attributable to a trade or business are allowed only to the extent of gross income not derived from a trade or business. (For this purpose, losses from casualty or theft, whether of business or nonbusiness property, are considered to be attributable to a trade or business.)

These rules are illustrated by Examples 1 and 2, following. Example 1 illustrates a case where conditions are such that casualty losses and gains and losses from sales of depreciable property used in the trade or business are all treated as ordinary gains and losses. Example 2 illustrates a case where such gains and losses are all treated as capital gains and losses (see page 27, Farmers' Tax Guide, under the heading, "Livestock and Other Property Used in Farming.")

Example 1:

Mr. Johnson had the following income and deductions for 1955:

Business Income:

Ordinary income from farming	\$2,000.00	
Ordinary income from grocery store	3,466.00	
Gain from sale of farm truck held more than six months (see Note "A")	390.00	
Wages (see Note "B")	<u>82.00</u>	\$5,938.00

Business deductions:

Ordinary deductions attributable to farming	\$5,244.00	
Ordinary deductions attributable to store	3,000.00	
Casualty loss on barn held more than six months (see Note "A")	1,000.00	
Casualty loss on house held more than six months (see Note "A")	<u>627.00</u>	<u>\$9,871.00</u>
Net loss from business		(\$3,933.00)

Nonbusiness income:

Long-term capital gain on sale of corporate stock (see Note "C")	\$ 900.00
Taxable interest income	<u>80.00</u>
Total nonbusiness income	\$ 980.00

Example 1 continued:

914152

Nonbusiness deductions:

Short-term capital loss on sale of
corporate stock (see Note "C") \$240.00

Itemized deductions from page 2,
Form 1040 (see Note "D") 607.00

Total nonbusiness deductions \$847.00 \$133.00
(see Note "E")

Net operating loss for 1955 (\$3,800.00)

Note "A". Having made the comparison explained on page 27 of the Farmers' Tax Guide, in preparing his return for 1955, Mr. Johnson reported his gain from the sale of his truck as ordinary income and reported his casualty losses as ordinary losses. For the purpose of computing a net operating loss, a casualty or theft loss of nonbusiness property (his personal residence) is treated as though it were a loss attributable to business.

Note "B". Wages and rental income are considered as business income, for the purpose of computing a net operating loss.

Note "C". Mr. Johnson's net long-term capital gain exceeds his net short-term capital loss by \$660 (\$900 - \$240). In computing a net operating loss, no deduction is allowed for fifty percent of such excess.

Note "D". This included all itemized nonbusiness deductions which are properly listed on page 2, Form 1040, except the casualty loss to Mr. Johnson's house, which, for this purpose, is treated as a business loss.

Note "E". The total nonbusiness deductions may not exceed the total nonbusiness income, and no deduction is allowed for personal exemptions.

Example 2:

Mr. Brown had the following income and deductions for 1955:

Business income:

Ordinary income from farming \$2,500.00

Capital gain from sale of animals
held for breeding purposes and
held for 12 months or more 1,500.00

Wages 150.00 \$4,150.00

Example 2 continued:

Business deductions:

Ordinary deductions attributable to farming		\$4,500.00
---	--	------------

Capital losses:

Loss on sale of farm machinery held more than six months	\$500.00	
--	----------	--

Casualty loss to farm truck held more than six months	<u>300.00</u>	
---	---------------	--

Total business capital losses	\$800.00	<u>\$5,300.00</u>
-------------------------------	----------	-------------------

Net loss from business		(\$1,150.00)
------------------------	--	--------------

Nonbusiness income:

Long-term capital gain from sale of land held for investment	\$200.00	
--	----------	--

Taxable interest income	<u>50.00</u>	
-------------------------	--------------	--

Total nonbusiness income	\$250.00	
--------------------------	----------	--

Nonbusiness deductions:

Short-term capital loss from sale of corporate stock -- \$300, only \$200, of which is deductible (see Note "F")	\$200.00	
--	----------	--

Itemized deductions from page 2, Form 1040, not including casualty and theft losses of nonbusiness property	<u>300.00</u>	
---	---------------	--

Total (not to exceed nonbusiness income)	\$500.00	\$250.00
--	----------	----------

"Net operating loss" for 1955		<u>0</u> (\$1,150.00)
-------------------------------	--	--------------------------

Note "F".. Nonbusiness capital losses are deductible only to the extent of non-business capital gains, even though there is an excess of business capital gains over business capital losses. However, in the event that business capital losses exceed business capital gains, section 39. 122-3 (c) of Regulations 118 should be consulted relative to the deductibility of such excess.

STEP II - Converting the 1955 "Net Operating Loss" to a 1953 "Net Operating Loss Deduction"

After determining the amount of the net operating loss for 1955, such net operating loss must be further adjusted, as required by the Internal Revenue Code of 1939, to determine the amount of the "net operating loss deduction" for 1953. To determine the amount of the "net operating loss deduction," the following steps should be taken:

(A) Recompute the 1953 "net income" with the following exceptions:

- (a) The deduction for depletion, if any, must be based on the cost or adjusted basis of the property, rather than on discovery value or a percentage of gross income from the property.
- (b) There must be included in gross income any interest received or accrued in 1953 which is wholly exempt from income tax. If interest was paid or accrued on indebtedness incurred to purchase tax-exempt securities, however, only the difference between the exempt interest income and the nondeductible interest expense need be included in gross income.
- (c) The deduction for capital losses may not exceed the capital gains included in gross income. It is not necessary here to distinguish between business and nonbusiness capital gains and losses, as required in Step I.
- (d) No deduction is allowed for fifty percent of the excess of a net long-term capital gain over a net short-term capital loss.
- (e) No net operating loss deduction resulting from the loss in 1955 or any other year is allowed.

Note: In recomputing the 1953 net income with these exceptions, any deduction which is limited in amount to a percentage of net income or adjusted gross income must also be recomputed. For example, the standard deduction and the deductions for contributions and medical expenses.

- (B) Determine the difference between the net income recomputed with the exceptions in (A), above, and the net income shown on the Form 1040 for 1953. Subtract such difference from the 1955 net operating loss determined under Step I and the resulting balance is the "net operating loss deduction" for 1953. To recompute the net income for 1953, as required by (A), above, it is a good idea to start with the adjusted gross income shown on the 1953 return, Form 1040. Such adjusted gross income can then be increased by the amount of the required adjustments and the net income recomputed accordingly. These rules are illustrated by Example 3, following:

Example 3:

On his return for 1953, Mr. Johnson showed adjusted gross income of \$3,000, and a net income of \$2,290. In computing his adjusted gross income, he listed on Schedule D a long-term capital gain of \$300 and a deduction for fifty percent thereof, or \$150. He had no deduction for capital losses or for depletion, and no net operating loss for any year except 1955. He received, in 1953, \$30 tax-exempt interest on State bonds. He contributed \$650 to his church in 1953, only \$600 (20 percent of \$3,000) of which he could deduct in computing his net income on his 1953 return.

His net income recomputed in accordance with the rules stated under (A), above, is as follows (for illustrative purposes, this example states all the required adjustments even though no amounts are shown for some of them):

Adjusted gross income shown on Form 1040 for 1953	\$3,000.00
--	------------

Adjustments:

(a) Excess of deduction for depletion based on discovery value or percentage of gross income from the property over depletion allowable based on cost	- 0 -
(b) Nontaxable interest on State bonds	\$30.00
(c) Excess of deductions for capital losses over capital gains	- 0 -
(d) Fifty percent deduction for excess of net long-term capital gains over net short-term capital losses	150.00
(e) Net operating loss deduction	- 0 - \$180.00

Adjusted gross income for 1953 as recomputed	\$3,180.00
--	------------

Nonbusiness deductions:

Taxes	\$ 50.00	
Interest	60.00	
Contributions (limited to 20 percent of \$3,180)	<u>636.00</u>	<u>\$746.00</u>

Net income for 1953 as recomputed	\$2,434.00
-----------------------------------	------------

Net income for 1953 as shown on the 1953 return, Form 1040	2,290.00
---	----------

Difference between net income recomputed and net income shown on the 1953 return	144.00
---	--------

1955 Net operating loss (see Example 1)	(<u>\$3,800.00</u>)
---	-----------------------

"Net operating loss deduction" for 1953

(\$3,656.00)

STEP III - Recomputing "Net Income" for 1953 and Determining the Amount of Refund

This step involves recomputing the tax liability for 1953, taking the net operating loss deduction into account. It should be noted that in computing the tax liability after application of the carryback, any deduction the amount of which is limited to a percentage of net income or adjusted gross income must be recomputed based on net income or adjusted gross income, as the case may be, after application of the carryback.

Example 4:

To carry the illustration forward, Mr. Johnson would recompute his tax liability for 1953 and determine the amount of the refund in the following manner:

1953 adjusted gross income per return (see Example 3)	\$3,000.00
Less: Net operating loss deduction (see Example 3)	<u>3,656.00</u>
Adjusted gross income after carryback	(656.00)
Less: Itemized nonbusiness deductions	<u>110.00</u>
Net income after carryback	(766.00)
Less: Exemptions	<u>1,200.00</u>
Amount on which tax is computed	- 0 -
Tax liability after carryback	- 0 -
Taxes paid on return for 1953	241.98
Amount of refund of 1953 taxes	241.98

STEP IV - Computing the Amount of the 1955 "Net Operating Loss" Which is Available as a "Net Operating Loss Deduction" In 1954

The portion of the net operating loss for 1955 which is available as a carryback to 1954 is the excess of such net operating loss over the 1953 net income recomputed in the manner described in Step II (A), except that, for this purpose, any net operating loss deduction for 1953 resulting from a loss in any year prior to 1955 is allowed.

Example 5:

The net operating loss deduction for 1954 is computed in the following manner:

1955 net operating loss (Example 1)	\$3,800.00
Less: Recomputed net income for 1953 (Example 3)	<u>2,434.00</u>
Net operating loss deduction for 1954	\$1,366.00

The net operating loss deduction for 1954 and subsequent years is the sum of the carryovers and the carrybacks to such years. Thus, the computation made in Step II to convert the 1955 net operating loss into a net operating loss deduction for 1953 is not required for these years.

STEP V - Recomputing the 1954 "Taxable Income" and Determining the Amount of Refund

This step, as in Step III, is merely a r computation of the taxable income for the year after taking the net operating loss deduction into account. In Step III, adjustments were required with respect to all deductions which were limited to a percentage of adjusted gross income or net income. For 1954 and subsequent years, it is not necessary to adjust the deduction for contributions because of a net operating loss carryback, but adjustment must be made to all other deductions which are so limited (for example, the standard deduction and the deduction for medical expenses).

Example 6:

Mr. Johnson's 1954 return showed adjusted gross income of \$4,740 and taxable income of \$2,800. He had itemized deductions of \$740, \$300 of which was for contributions to his church. His taxable income is recomputed as follows:

Adjusted gross income shown on Form 1040 for 1954		\$4,740.00
Less: Net operating loss deduction (Example 5)		<u>1,366.00</u>
Adjusted gross income after carryback		3,374.00
Less: Itemized deductions	\$ 740.00	
Exemptions	<u>1,200.00</u>	<u>1,940.00</u>
Taxable income after carryback		1,434.00
Tax liability after carryback		286.80
Taxes paid on 1954 return		<u>560.00</u>
Amount of refund of 1954 taxes		\$ 273.20

How To Claim a Refund

Any refund due as a result of a net operating loss may be obtained by filing Form 1045, Application for Tentative Carryback Adjustment, or Form 843, Claim for Refund. If an application for a tentative adjustment is made it must be filed on or after the date of filing the return for the loss year, but not later than one year from the end of the loss year.

A copy of the computations made in Steps I, II, and IV must be submitted with the application. The computations made in Steps III and V are reflected on pages 2 and 3 of the Form 1045.

Every line on page 1 of Form 1045 should be filled in. If the tax table is used to compute the tax liability for either 1953 or 1954, the refund should be computed on page 4 for such year in lieu of page 2 or 3.

The Internal Revenue Service will generally act on Form 1045 within 90 days from the date the Application is filed. If for any reason all or a part of the Application is rejected, it may be necessary to file a Claim for Refund, Form 843. Also, if there are other items which require adjustment, it will be necessary to file Form 843 or an amended return.

It is suggested that the instructions on page 4 of Form 1045 be read carefully.

The information and computations from Examples 1, 3, 4, 5, and 6 are used in completing the attached Form 1045, in order that you may see how to reflect this information on an Application for a Tentative Carryback Adjustment.



